Supreme Court, U.S.
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No. 91-947

In the Supreme Court of the United States

OCTOBER TERM, 1991

SOL FINKELMAN, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTION PRESENTED

Whether a taxpayer who exchanges non-recourse notes for property in a sham transaction that unrealistically attributes a substantially incorrect value to the property (for the purpose of obtaining inflated depreciation and interest expense deductions) should be deemed to have a basis in the property of zero or a basis equal to the fair market value of the property (i) for purposes of depreciation and interest expense calculations and (ii) for purposes of computing the overvaluation penalty imposed by 26 U.S.C. 6659 (1988).

TABLE OF CONTENTS

	Page
Opinions below	1
Jurisdiction	1
Statement	2
Argument	6
Conclusion	9

TABLE OF AUTHORITIES

Cases:

Gilman v. *Commissioner*, 933 F.2d 143 (2d Cir. 1991), cert. denied, 112 S. Ct. 871 (1992)	
Pleasant Summit Land Corp. v. *Commissioner*, 863 F.2d 263 (3d Cir. 1988), cert. denied, 493 U.S. 901 (1989)	5, 6, 7

Statutes and rule:

Revenue Reconciliation Act of 1989, Pub. L. No. 101-239, § 7721(a), 103 Stat. 2395	4
26 U.S.C. 6651(a)(1)	4
26 U.S.C. 6653(a) (1988)	4
26 U.S.C. 6659	7, 8
26 U.S.C. 6659 (1988)	4
26 U.S.C. 6659(c) (1988)	5, 7
26 U.S.C. 6662(b)(1) (Supp. I 1989)	4
26 U.S.C. 6662(b)(3) (Supp. I 1989)	4

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OPINIONS BELOW

The memorandum and orders of the court of appeals affirming the Tax Court (Pet. App. 72) and denying rehearing (Pet. App. 73) are not reported. The opinion of the Tax Court (Pet. App. 1-69) is reported at 56 T.C.M. (CCH) 1269. The order of the Tax Court denying petitioner's motion for leave to file a motion for rehearing (Pet. App. 70-71) is unreported.

JURISDICTION

The judgment of the court of appeals was entered on July 10, 1991. The petition for rehearing was denied on September 11, 1991. Pet. App. 73. The petition for a writ of certiorari was filed on Decem-

ber 10, 1991. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. Petitioner is a certified public accountant and investment counselor who, during the years at issue, specialized in guiding clients toward transactions in commercial real property under long-term leases to single tenants (Pet. App. 4-5). Beginning in the late 1960s, petitioner engaged in approximately 50 transactions with Joseph Penner, a real estate developer who built and owned commercial buildings leased on a long-term basis to large tenants such as the United States Postal Service (*id.* at 5-6, 11-12, 19, 24, 29, 35). These transactions involved partnerships (consisting of petitioner, his son,[1] his clients, and other investors) that purported to acquire real property from Penner subject to long-term leases[2] and to substantial outstanding indebtedness. Petitioner described these partnerships to his clients as "Tax Oriented Ventures" (*id.* at 9).

The stated price under which the partnerships purportedly acquired these properties was always substantially higher than their fair market value (Pet. App. 57). In the typical transaction, the partnerships would make a small down payment and would give Penner a non-recourse note for the remainder of the agreed price (*id.* at 8, 14, 36). These notes typically bore interest at below market rates (*id.* at

[1] Petitioner and his son did not invest in these partnerships, but received a partnership interest in exchange for services (Pet. App. 10, 17, 23, 28, 34, 37-38).

[2] In the five selected transactions, the leases had initial terms of 22 to 30 years and long-term renewal options (Pet. App. 11-12, 19, 24-25, 29, 35).

9, 14, 20, 25, 31, 36). The periodic payments due on the notes were calculated to approximate the amounts coming due from the tenants under the existing leases, and the tenants usually made these rental payments to an independent trustee, or directly to Penner, rather than to the partnerships (*id.* at 8, 20-21, 26, 30-32, 37). As the result, the partnerships generally made no payments to Penner for the properties other than the initial small downpayments.

The partnership notes called for significant balloon payments to be made to Penner ten to 15 years after the transaction commenced, with further balloon payments due for the balance of the purchase price at the time that the underlying long-term leases ended (Pet. App. 8, 20, 25-26, 31, 36).[3]

2. The partnerships filed tax returns for 1975 through 1982, in which they claimed deductions for depreciation of their interest in the properties based on the price each had purportedly paid (Pet. App. 15, 21-22, 26-28, 32-34, 37-38). The partnerships also claimed deductions for interest accrued under the non-recourse notes (*id.* at 15, 21-22, 26-28, 32-34, 37-38). Since the partnerships applied the accrual method of accounting (*id.* at 17, 23, 28, 34, 38), they deducted accrued interest whether it had been paid or not (*id.* at 59). The resulting interest and depreciation deductions were passed through to the partners, including petitioner, who claimed them on their individual income tax returns (*ibid.*).

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[3] At the time of the Tax Court proceedings, the balloon payments on only three of the approximately 50 properties subject to these agreements had come due (Pet. App. 10). One of the properties was sold before the balloon payment due date, one of the balloon payments was made, and the third balloon payment became due but was not paid (*ibid.*).

The Commissioner denied the deductions and asserted additions to tax for failure to file a return or to pay tax under 26 U.S.C. 6651(a)(1), for negligence under 26 U.S.C. 6653(a) (1988) and for overvaluation under 26 U.S.C. 6659 (1988) (Pet. App. 2).[4]

3. Petitioner sought a redetermination of the resulting deficiencies in the Tax Court. The parties agreed that petitioner's case would be tried as the "lead" case and that the result in this case would be binding for all partnerships managed by petitioner (Pet. App. 3). Five "test" properties were selected for extensive findings and analysis (*id.* at 4).

The Tax Court sustained the tax deficiencies determined by the Commissioner, concluding that the transactions were an economic sham and that "no sale occurred for income tax purposes" (Pet. App. 64). The court found that the transactions were not negotiated at arms length and that the fair market value of each of the five properties was significantly below the price ostensibly paid for those properties (*id.* at 39, 55-59). Apart from the relatively small cash down payments, no money flowed from the partnerships to Penner because the periodic loan payments on the non-recourse notes were made from the rentals coming due, leaving Penner in the same economic position as before the "sale" occurred (*id.* at 59-60). In view of the inflated "sale" prices, it was highly unlikely that the properties would appreciate in a sufficient amount to cover the stated purchase price by the time the balloon payments

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[4] 26 U.S.C. 6653(a) and 6659 (1988) were redesignated 26 U.S.C. 6662(b)(1) and (3) (Supp. I 1989), respectively, by Section 7721(a) of the Revenue Reconciliation Act of 1989, Pub. L. No. 101-239, 103 Stat. 2395.

came due (*id.* at 61). The tax motivation of the transactions was transparent, for the "sales" were ordinarily closed near the end of the tax year (*id.* at 63-64) and petitioner emphasized the tax advantages of the "sales" in his correspondence with his clients and partners (*id.* at 64). Because the transactions were a sham, the claimed deductions were disregarded (*ibid.*).

The Tax Court also upheld the penalty under 26 U.S.C. 6659(c) (1988) for an underpayment of tax attributable to a valuation overstatement at the maximum rate of 30% that applies to overvaluations of more than 250% (Pet. App. 66). Relying on its previous finding (*id.* at 64) that "no sale occurred," the court held that, since the partnerships' basis in the properties was zero, the overvaluation was greater than 250%, and the transaction was therefore subject to the maximum 30% penalty (*id.* at 66).[5]

On June 27, 1989, petitioner moved for leave to file a motion for reconsideration of the Tax Court's decision, arguing for the first time that, under the rationale of *Pleasant Summit Land Corp.* v. *Commissioner*, 863 F.2d 263 (3d Cir. 1988), cert. denied, 493 U.S. 901 (1989), the partnerships possessed a bona fide economic interest in the properties to the extent of their fair market values and that the transactions should therefore not be entirely disregarded for tax purposes. Noting that petitioner's motion was almost 100 days overdue, the Tax Court denied it without reaching the merits of petitioner's new claim (Pet. App. 70-71).

Petitioner appealed. In an unpublished order, the court of appeals affirmed "for the reasons set forth

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[5] The Tax Court did, however, strike the negligence penalty and the overvaluation penalty as applied to properties held by the taxpayer for more than five years (Pet. App. 67-68).

in [the Tax Court's] February 16, 1989 memorandum opinion" (Pet. App. 72).

ARGUMENT

1. Petitioner does not challenge the fact findings of the Tax Court that the properties were substantially overvalued, that negotiations were not conducted at arms length, that the partnerships incurred no genuine indebtedness, that no "sale" of the properties occurred for tax purposes, and that the partnerships' basis in the properties was therefore zero. Petitioner nevertheless argues that his deductions should be partially recognized, rather than totally disallowed (Pet. 11-17). Petitioner reasons that even a purchaser who buys overvalued property subject to non-recourse debt has an economic incentive to pay off the debt up to the fair market value of the property; conversely, he asserts that the creditor will refrain from foreclosing if the debtor offers him at least the property's fair market value (Pet. 13-17). Since this reasoning was the basis for the Third Circuit's partial allowance of depreciation and interest deductions in *Pleasant Summit Land Corp.* v. *Commissioner*, 863 F.2d at 276-277, petitioner asserts that the unpublished decision of the court of appeals in the present case creates a conflict among the circuits that requires resolution by this Court.

There is, however, no conflict between *Pleasant Summit* and the decision in the present case. The Tax Court's opinion in this case, which was affirmed by the court of appeals, is premised on its findings that the partnerships, in fact, never purchased the properties in the first place (Pet. App. 64). Since the transactions were economic shams, they were to be disregarded in their entirety, as were the associated claimed deductions for depreciation and inter-

est expense. The court's conclusion that the transactions involved in this case were economic shams that involved no bona fide obligations on either side of the purported "sales" is clearly supported by the Tax Court's findings (see *id.* at 54-62), and petitioner does not contend to the contrary.

In contrast, in *Pleasant Summit*, the court assumed that a bona fide and effective "sale" had occurred, that the taxpayer held the property "subject to a nonrecourse debt in excess of the market value of the property" (863 F.2d at 276), and concluded that the part of the debt that represented the market value of the property represented a bona fide indebtedness to be recognized for tax purposes (*ibid.*). The court's conclusion in *Pleasant Summit* that a bona fide sale had occurred—with an associated bona fide indebtedness for at least part of the sale price—distinguishes that decision from the present case. Under the findings of the Tax Court in this case, since the transaction was a sham and no effective "sale" occurred, the taxpayer lacked a sufficient interest in the property to claim *any* basis in the property or to claim any associated depreciation or interest expense.

2. While conceding that he substantially overvalued the properties involved in this case, and that some penalty under Section 6659 is therefore warranted, petitioner argues that the penalty should not have been assessed at the maximum statutory rate of 30% (Pet. 20-23). Section 6659 provides a graduated series of penalties, depending on the percentage by which the value claimed by the taxpayer exceeds "the value of any property, or the adjusted basis of any property." 26 U.S.C. 6659(c) (1988). The Tax Court upheld an overvaluation penalty of 30%, the maximum provided by the statute for overvaluations of 250% or more (Pet. App.

66). The court reasoned that the overvaluation was more than 250% because, "[s]ince no sales are recognized for tax purposes, the correct adjusted bases are considered to be zero" (*ibid.*).

Petitioner claims that, even though his basis in the properties was zero, the court should have compared the falsely inflated value of the properties that he claimed on his returns to the fair market value of the properties in computing the overvaluation percentage under Section 6659. Petitioner's argument is based on a misunderstanding of the statute.

The overvaluation to which Section 6659 refers is the difference between the value claimed by the taxpayer and the value that he is entitled to claim in computing his deduction. Since the Tax Court found that the transactions were a sham and that no effective sale had occurred, the taxpayer was not entitled to claim *any* value for the properties in computing his deductions. It was therefore proper for the Tax Court to compare the value claimed by the taxpayer against the zero basis that the taxpayer was entitled to claim in the property in computing the percentage by which the taxpayer had overvalued the property on his returns.

In *Gilman* v. *Commissioner*, 933 F.2d 143 (1991), cert. denied, 112 S. Ct. 871 (1992), the Second Circuit reached a similar conclusion. In *Gilman*, the taxpayer contested the imposition of the maximum Section 6659 penalty to a transaction for which that court found that no true sale occurred. The taxpayer argued that, since the sale was disregarded and he therefore had "no basis" in the property, Section 6659 was inapplicable because the taxpayer's error was not a valuation error but an error in claiming *any* deduction. 933 F.2d at 150. The Second Circuit rejected the taxpayer's argument, holding that it would lead

to the absurd result, obviously not intended by Congress, that the Commissioner would be able to impose a higher penalty on a valuation that was partially disallowed than on one that was wholly disallowed. *Id.* at 150-151. In addition, the Second Circuit noted that application of the penalty in this context would further Congress's goal of curbing abusive tax shelters. *Id.* at 151. Since the court upheld use of a zero basis for the property in calculating the overvaluation penalty in *Gilman*, the taxpayer was liable for the maximum 30% penalty, as in the instant case. *Id.* at 149.

The decision in this case is consistent with *Gilman* and does not conflict with any decision of this Court or of the other courts of appeals. Further review is therefore not warranted.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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